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Residential Tenancies

Rent Regulation and Rental Market Problems

Clayton Research Associates Limited

Research Study No. 10

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by

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INTRODUCTION

The goal of this study is to evaluate rent regulation as a policy instrument for stabilizing rent levels.[1] To this end, it reviews the operation of the rental market and evaluates past and current policies and programs (including rent regulation) directed at that market in terms of their success in stabilizing rents.

Throughout, the emphasis is on the interplay of market forces, an approach that may surprise readers familiar with some recent, popular works on the subject. Many of these analyses appear to omit the fact that rental housing, like corn, toothpaste, or the services of economic consultants, is traded in a market. Potential "buyers" (renters) demand rental housing, and "sellers" (landlords) supply it; the interaction of the two forces creates "prices" (rent levels), and "transactions" (rentals) occur in which "buyer" and "seller" exchange valued items (money and a rental unit). The normal laws of demand and supply apply: if demand increases, supply responds; if demand outstrips supply, prices rise; if prices rise, demand falls as some renters "purchase" smaller quantities (rent smaller or lower-quality units) or substitute another good; and so on.

Like any market, the market for rental housing has its quirks and idiosyncrasies, some intrinsic to this particular good, some the result of custom or law. Nevertheless, the general market forces prevail. To forget that fact is to misunderstand the situation at the outset.

The Structure of This Study

One idiosyncrasy of any rental-housing market must be stressed at the outset: it has spatial limits of a kind that do not exist in the markets for goods or services that can be transported from one place to another with relative ease. Thus, to speak of the Ontario rental-housing market is to use a convenient fiction. Rather than a provincial market, what exists is a series of regional and local rental-housing markets focused on population and employment centres. Some spillover occurs between adjacent centres, such as Oshawa and Toronto, but rental-market conditions in, say, Thunder Bay or Cornwall have little relation to those in Ottawa or Toronto. Nevertheless, the factors behind demand and supply tend to be similar in all rental-housing markets; also, most legislation affecting rental housing is provincial, and the majority of government policies and programs relating to the market have been province- or nation-wide. Therefore, in order to simplify the discussion, this study generally refers to Ontario as a whole. To discuss each market separately would add little to an understanding of the larger market forces involved but would add significantly to the length and complexity of the analysis.

The study is structured in five sections. First come two background reviews of the rental-housing market: a description of overall demand and supply (an appendix offers more detail) and a summary of the interplay between them.

The next section identifies those features of the rental market that may give rise to market failures or imperfections and thus may allow landlords to maintain rents that deviate from competitive market levels. The fourth section describes past and present policies and programs related to the rental market and evaluates their effectiveness in stabilizing rents. The final section assesses rent regulation as a means of dealing with the types of market failure identified previously.

OVERVIEW OF THE RENTAL MARKET

To set the stage for an analysis of imperfections in the rental-housing market in Ontario, this section reviews some of the factors behind and the interplay between demand and supply in that market.[2]

The Demand for Rental Housing

All families and individuals need housing. Setting aside the relatively small proportion who are institutionalized or receive housing as part of remuneration for work, people may choose to rent a dwelling unit of their own, to purchase such a unit, or to share accommodations with another family or individual. The decision to rent, own, or share is based on a number of considerations, including the relative cost of each option, the space requirements and resources of the

individual or family involved, and the availability of suitable accommodation.

The 1981 census reported almost 1.1 million Ontario households that had chosen to rent; that number is estimated to have grown by an average of 17,000 annually during 1981 through 1984.

Characteristics of Ontario's Renter Households

Ontario's renter households are highly varied: family and non-family (a non-family household is one composed of a single person or two or more unrelated people), young and old, rich and poor. Differences between the types and age profiles of renter and owner households, as reported in the 1981 census data, indicate a pronounced lifecycle tendency in the choice of accommodation.

- Almost half of all renter households are headed by a person less than thirty-five years of age. This statistic reflects the facts that most young unmarried adults are renters and that many young couples rent before purchasing their first home. In many cases, the reason for renting, rather than owning, is inability to pay the costs of ownership or the need to save for a down payment on a purchase. Other young people simply prefer the lifestyle of renting.

- Households with heads aged thirty-five to sixty-four are more likely to own than to rent. (For households with

heads about fifty years of age, the proportion of owners rises to more than 75 per cent.) A large number of the middle-aged households that do rent appear to do so simply because they cannot afford to own.

- Among households with heads aged fifty-five or older, the proportion of renters increases again. In many cases, this shift probably reflects the reduced accommodation needs of families whose children have left home or in which one of the spouses has died. The availability of more-suitable (sometimes subsidized) rental units may also induce some older people to sell their homes. In some cases, too, the lowered incomes associated with age may cause home-owners to sell, realize their equity, and move into rental units.

The fact that the choice between owning and renting is partly influenced by lifecycle tendencies should not cloud the fact that many households rent because they cannot afford to own. The distribution of incomes among renters is very wide. Census data show that in 1980 some 43 per cent of non-family households and 21 per cent of family households that rented had incomes of less than $10,000. At the other end of the scale, 12 per cent of non-family households and almost 33 per cent of family households that rented had incomes of more than $25,000. The 1980 median income for non-farm renter households in Ontario was about $15,500; the comparable figure for all households in Ontario was $22,600.

How many of Ontario's renter households have difficulty affording even rental accommodation? Some sources put the figure for recent years at about 18 per cent, some as high as 29 per cent. (The differences arise from variations in data bases and in methods of calculation as well as differences in establishing an appropriate rental/income ratio for a threshold.)[3] Whichever data and definitions are used, it is clear that most renters have little difficulty affording their current accommodations, but a significant minority must devote a very large proportion of their incomes to rent payments.

Effective Demand and Price

In brief, of the numerous Ontarians who demand rental housing, a large proportion, particularly among the young, are in the rental market only temporarily; ultimately, they aspire to be home-owners. Others are more permanent renters, some by choice and some by necessity. For many low-income households, renting is the only housing option available since they do not have the resources to purchase homes of their own and family circumstances require them to maintain separate dwellings, rather than share accommodations.

The majority of renters, however, do have other options, and because these options exist, the demand for rental accommodation is sensitive to the price of rental

units. A rise in rents will lead to some diminution of the overall quantity of rental housing demanded because:

- Some of the people who regard their stay in rental housing as a temporary expedient prior to becoming home-owners will accelerate their purchases because of the increased rents.

- Some people, particularly young single people, will decide to "double up" or move back with their families rather than bear the increased rents. Some elderly people, especially widows or widowers, will do the same thing.

- Some renters will decide to move to smaller or lower-quality accommodations that are less expensive.

Many renters will not change their accommodations because of increased rents -- some because they do not have viable options. Nonetheless, in the rental-housing market as in most types of markets, the overall quantity demanded varies inversely with price -- the higher the rent, the lower the quantity demanded: the lower the rent, the higher the quantity demanded.

Growth in Demand

Another important characteristic of most rental markets in Ontario is that <u>total</u> demand has been growing and will continue to do so for some time. Between 1971 and 1981,

population growth and trends in lifestyles and affordability resulted in an annual average increase of about 26,500 in the number of renter households. Projections show a lower growth rate in the future because of a combination of demographic factors, such as the "baby-boom" population's moving out of the prime age groups for renting, and economic factors, such as unemployment among the young and increased rents for new rental accommodations. Nonetheless, during the first part of the 1980s, rentals grew in Ontario by an average of 17,000 households annually.

The Supply of Rental Housing

The supply of rental housing comprises the stock of existing rental units of all types plus incremental additions as new units are completed less any losses from demolitions and conversions to owned housing or nonresidential use. The characteristics of this stock and its owners are germane to any discussion of the market for rental housing, as are the motivations of the companies and individuals that supply it.

The Characteristics of the Rental Stock

Among the important characteristics of Ontario's rental-housing stock are:

- A large and increasing proportion of Ontario's rental stock is apartment units. In 1981, apartments accounted for

about two-thirds of the occupied rental stock and for almost 80 per cent of the newer units (those completed since 1961), according to census data.

- Most of Ontario's occupied rental stock is located in urban areas. About 75 per cent of it is in the province's ten Census Metropolitan Areas (CMAs),[4] 42 per cent in the Toronto CMA alone. In contrast, large urban areas have a much smaller proportion of the province's owner-occupied housing; for example, only 31 per cent is in the Toronto CMA.

- Most of Ontario's rental housing -- more than 85 per cent -- is in privately owned buildings.

Owners of the Private Rental Stock

The owners of Ontario's private rental stock, like the tenants who occupy it, are highly diverse. Corporations predominate; an analysis, conducted by the Ontario Ministry of Municipal Affairs and Housing in 1982, using 1980 data from a sample of rental apartment buildings in urban areas, indicates that 37 per cent of the landlords were companies, but they owned 76 per cent of the units involved.[5] In contrast, 44 per cent of the landlords were individuals or couples, but they owned only 12 per cent of the units in the sample.

Clearly, the majority of larger apartment buildings are in the hands of corporations: the corporate landlords in

the sample averaged 160 units each, while the individuals and couples averaged only twenty units, often in more than one building.

Nevertheless, the large rental buildings are not all in the hands of large real estate companies. More than half of the corporately owned units in the sample were owned by companies with portfolios of only one or two buildings. Companies owning six or more rental buildings accounted for only 21 per cent of all the units.[6]

The Motivation of Landlords: Return on Investment

Whether landlords are large or small, individuals or companies, their prime motive for investing in rental housing is to obtain a return on their investment that at least matches the return on alternative investments of similar risk. This return is available in two ways:

1. The difference between rental revenue and the costs of financing and operating the rental property. In the early years of new rental projects, this figure is frequently negative, but it is generally expected to move in the landlord's favour as market rents rise with inflation, assuming no major change in interest rates so that financing costs remain more or less constant.

2. Capital appreciation. In an inflationary environment, one can expect the value of a rental property to increase

over time, partly as a function of the improved cost-revenue relationship and partly as a function of the increase in replacement cost (as the costs of land, materials, and labour reflect inflation).

To determine the return on investment for a particular project, a potential investor must assess all its probable costs and revenues. The costs for any rental project include the purchase cost, interim and final financing costs, marketing costs, and operating costs, including management, maintenance, and utility charges and taxes. New projects also entail the cost of assembling and holding the land, the expenses involved in designing the project and negotiating with appropriate agencies regarding its various aspects, and actual construction costs. By adding the required return on initial equity to estimates of these costs, the potential investor can establish a schedule of the current and future costs that must be covered.

The revenue side of the calculation is obtained by examining rents in comparable projects and assessing likely trends in rental-market demand. This exercise establishes both the likely initial level of rents and the prospects for increasing them in the future. It also provides information on the prospects for appreciation of the project's capital value.

The projected revenue schedule is then compared with what real estate analysts call the project's "economic rents". This term (which must be distinguished from the

word "rent" as it is generally used in economics) signifies the rent a property must bring in over the long term to cover costs and to provide a reasonable return on equity, taking account of expected capital appreciation. In other words, economic rents are those the project must generate if it is to be an attractive investment.

Generally, if an investor in rental housing cannot expect to obtain a long-term rate of return that is equal to or higher than the rate of return on alternative investments with comparable risks, the rental property is not an attractive proposition, and the investment is unlikely to occur.

Of course, not all potential investors undertake detailed analyses of the returns available from all alternative investments. Neither do all investors view a rental project from the same perspective. For example, some investors, mainly small ones, find a symbolic value in real property that makes it more attractive than other investments with superior returns. Also, real estate companies looking to reduce their taxable income may be attracted to rental projects that do not appear viable in their own right. (The tax laws permit real estate companies to deduct capital cost allowance - CCA - and other losses on rental properties against income from other sources, whereas most other companies and individuals cannot deduct CCA.) Nonetheless, as a general rule, rental housing is an attractive investment only if the current and expected cost-revenue relationships, together with the prospects of future

capital gains, offer a return on investment sufficient to justify the risks and efforts involved.

Thus, the importance of attractive returns on investment in creating new rental supply should not be underestimated. If there are no prospects of such returns, investors will generally not build new rental housing. If, on the other hand, the prospects appear positive, new supply should be forthcoming. The range of potential investors in rental accommodation is very broad, especially in the major rental markets. Current landlords, home-builders, developers of other types of real estate, and individuals on their own or as part of a syndicated venture can be expected to consider developing new rental projects if they offer attractive returns.

THE OPERATION OF THE PRIVATE RENTAL MARKET: THEORY AND REALITY

With rental housing, as with any commodity or service, the market is primarily a function of the interaction of the forces of demand and supply. As shown in the previous section, demand is provided by the families and individuals who, for one reason or another, choose to live in rental accommodation. Most of the supply has traditionally been provided by private companies and individuals who are seeking returns on their investment.

In a rental-housing market that is functioning normally, disequilibrium leads to changes in the vacancy

rate and rents and thence to appropriate adjustments in demand or supply.

Differences in the levels of demand and supply are reflected by changes in the level of the vacancy rate -- the proportion of the rental stock that is vacant at any given time. Traditionally, a vacancy rate of 2 to 3 per cent in the Canada Mortgage and Housing Corporation's semiannual survey has been regarded as indicative of a balanced rental market.

The vacancy rate is also a traditional rough indicator of landlords' profit levels. When vacancy rates are low, almost all rental units are occupied and producing revenue; as a result, total revenues are greater than when vacancy rates are high.[7]

Also, in the absence of controls, landlords are more likely to be able to impose increases in rents when vacancy rates are low since tenants then have fewer alternatives than when vacancy rates are high. Markets with high vacancy rates are frequently characterized by stable or declining rent levels as landlords attempt to attract new tenants and keep old ones.

Changes in the vacancy and rent levels serve to attract or discourage both additional supply and additional demand. Markets with tight vacancies and rising rents encourage additional supply since investors can expect enhanced revenues from rental investments. At the same time, the higher rents can be expected to reduce demand to some extent: some renters, especially some of those who regard

rental housing as a temporary measure, will opt for home-ownership since the relative costs of renting have increased; others, especially young single people, will find sharing accommodations, perhaps with parents, more attractive.[8] The opposite movements tend to occur in over-supplied markets with high vacancy rates and low (or possibly negative) rent increases.

In a balanced rental market, a tenant who perceives a particular unit's rent to be too high or its standard of maintenance poor has the option of moving to another rental unit (or perhaps to another kind of housing). This mobility protects most tenants from excessive rent increases since the costs associated with vacancies (loss of rent revenue, advertising and marketing costs, and repainting and cleaning expenses) are significant to landlords.[9]

Of course, a tenant who seeks alternative accommodations also incurs information and transaction costs, such as moving expenses -- not to mention the nonpecuniary costs involved in moving a household from one location to another. In many cases, these costs are high relative to the tenant's income and, all things considered, are a deterrent to moving, even if a less expensive or more suitable unit is available elsewhere. Also, since rental units are not homogeneous in quality, size, or rents and are all in different locations, a tenant's ability to find suitable alternative accommodation may be limited even in a balanced market. Nevertheless, considerable sensitivity to price and quality exists in a normally functioning rental market.

The Constraint of New Supply

Elementary economic theory suggests that continued low vacancy rates in a rental housing market should elicit additions to supply. Yet in most Ontario centres in recent years, total vacancy rates have been low, but new rental construction has generally not been forthcoming. Few investors are willing to undertake new projects without substantial government assistance. Almost all the province's new rental construction since the mid-1970s has been subsidized through various federal or provincial housing programs, which are detailed in the final section of this study.

Clearly, investment in new rental projects has become less attractive than alternative investments. Why? The reasons are complex. Following is a brief review.

- In most Ontario markets, economic rents -- the rents necessary both to cover costs and to provide a reasonable long-term return on equity invested in new rental housing -- are well above the rents prevailing for similar units in the existing stock -- even those in the uncontrolled rental stock. This phenomenon is a result of increases in financing and construction costs and the constraints on overall market rents caused by rent regulation and past government subsidies for private rental projects. When potential developers realize that they must either set rents below the economic level or face high vacancies, rental housing is not an attractive investment.

- Many landlords perceive a shift in the balance of landlord-tenant legislation in favour of tenants. This perception is based partly, but not wholly, on the existence of rent regulation in Ontario. The new security-of-tenure provisions in the 1975 Landlord and Tenant Act have also increased landlords' risks. Concerns that the system will not treat landlords fairly, coupled with the image of militant tenants, have not enhanced the attractiveness of rental housing as an investment vehicle.

- Potential investors have a concern, substantiated by observation of events in some other provinces, that Ontario may extend its regulation to cover properties now exempt from the rent-review process. Most new rental developments depend on progressive increases in rents for economic viability since most new projects, even if subsidized, incur negative cash flows in their early years. With Ontario's opposition political parties actively advocating the extension of rent regulation to projects built after 1975, investors are worried about the long-term economic viability of new projects.

- Demographic trends point to a long-term decline in the rate of increase in the demand for rental housing. Although no one foresees an actual decline in total rental demand, investors find current projections less favourable than those of the 1970s.

Some analysts regard these phenomena as evidence of chronic market failure -- evidence that Ontario's rental markets cannot respond, without government intervention, to the demand for new rental housing. Others, including the authors, do not agree. A complete analysis of this debate is beyond the scope of this study, as is the proposal of solutions to the problems of stimulating new supply. These problems are outlined here simply as part of the presentation of background on conditions in Ontario's private rental markets. Such a background is necessary to assess the desirability of rent-regulation as an instrument for stabilizing rents in Ontario.

RENTAL MARKET FAILURE

When analysts or politicians advocate intervention in the rental market in order to stabilize rents, they are contending that rental markets have failed -- that they do not work efficiently to achieve equilibrium rents. Yet apparent instances of failure in a given market may not be true cases of failure at all, or they may be failures that arise not from market imperfections but from other causes, such as previous interventions in the market. Moreover, intervention in a given instance, whether it is a case of true failure or not, may leave the market worse off than before. An ideal program of stabilization would aim at overcoming the market's failures while allowing its essential elements to operate to achieve a new equilibrium.

This section reviews the problems and characteristics of Ontario's rental markets that might be construed as market failures.

Potential Types of Market Failure

A market that is perfectly competitive, in the traditional economic sense, is achieved almost nowhere in modern economies. Virtually all parts of our economy are subject to some forms of market failure -- some breakdowns of the competitive economic model -- which can be construed as justification for regulatory intervention on behalf of consumers, producers, or society as a whole. Common instances of market failure include: perpetuation of a monopoly situation; a lack of complete information available to all the economic actors; external benefits or costs incurred by unconsulted third parties (externalities); the inability of the economy to utilize all resources fully (the traditional example is unemployment); goods and services whose distribution cannot be limited at no cost or at low cost in relation to the cost of production; and limitations on the distribution of scarce resources to which all members of society have a right.[10]

The rental market, like other modern markets, undoubtedly has imperfections that cause it to deviate from the perfectly competitive model. Although not all the standard examples of market failure are relevant here, some aspects of the rental market may give rise to excess

profits, disequilibrium, inefficiencies, and so on, causing rent levels to deviate from the competitive norm. A list of situations that may be considered evidence of rental-market failure is presented below. (Discussion as to whether they actually do indicate market failure is reserved for the following section.)

- Most rental markets in Ontario are very tight, especially for dwelling units at the lower end of the rent range. New private rental projects are almost invariably targeted at renters able to afford high rents despite the very low vacancy rates that signal need in the lower-rent stock. The market is not directly responding to this need.

- The costs of land (particularly in desirable locations) and of construction appear to be rising constantly. Since unconstrained market rents generally tend to rise to the level necessary to stimulate new construction, the rents for older units built at lower costs rise despite the fact that these buildings have no corresponding cost increases. These rises disadvantage tenants in the existing stock and confer on the owners abnormal or excess profits that they may not deserve.

- Particularly desirable parts of cities have only a fixed amount of land, and little of it becomes available for new construction in any given year. Because it is in demand, land in these areas tends to be priced higher than land in other locations, and consequently higher-rent units

tend to be built there. In some cases, landlords find it profitable to demolish existing buildings in these areas and replace them with higher-rent new ones. The desirability of such areas also leads to the competitive bidding up of rents for the existing stock located there. Such a pattern of rising rents effectively excludes lower-income tenants from living in these areas and thus erodes the amount of rental stock available for them.

- Planning and constructing a new rental building require a long lead time, so rental supply is very slow to respond to increases in demand. While the market is in the process of responding, existing tenants face a shortage of alternative accommodations, so their landlords have an opportunity to impose excessive rent increases.

- Land-use controls restrict the areas in which developers may build new rental projects. If insufficient amounts have been pre-zoned for high-density housing, the cost of land is generally pushed up. If building on a specific site requires a successful re-zoning application, the production process is delayed. By restricting supply, land-use controls also tend to hinder competition; developers cannot enter the market as freely as they could if it were perfectly competitive.

- Rental markets are essentially oligopolistic (that is, the actual and potential suppliers are few), so landlords may be able to collude to obtain rents higher than they

could obtain in a free rental market. Oligopolistic landlords can also restrict supply and subvert the natural market reactions to higher rents.

- Some tenants, such as elderly or disabled people, have relatively little choice in their accommodations. Low incomes, problems of mobility, and limited information about alternatives make such tenants vulnerable to exploitation by landlords, who may charge them rents higher than market rents.

- When assessing the economics of new rental investment, investors and financial institutions often do not take adequate account of likely rent inflation or capital appreciation. For investors, this tendency leads to the setting of relatively high required rates of return on initial investment in the early years of the project. For lenders, it leads to the giving of relatively low first mortgages on rental properties; consequently, many developers must resort to expensive second and even third mortgages. As a result, the economic rents on new rental projects are often higher than they would be if adequate account had been taken of likely capital appreciation and future increases in revenue.

Assessment of Potential Types of Rental Market Failure

Each of the situations above can be described as a potential case of rental-market failure. Much of the rest of this

paper is an attempt to determine whether any or all are actually instances of failure in the current rental-housing markets of Ontario.

Before considering this question, however, one must recall that those markets have been subject to control for almost a decade and that a variety of other interventions (such as zoning restrictions, building codes, construction subsidies, and the municipal approval process generally) have long affected their operation. As a result, rental markets in the province are not now, and have not been for some time, operating in the manner in which a totally free rental market would operate.

In examining these issues, it is also important to recognize that there are some things a market cannot do. The outstanding example in the context of this paper is that the private rental market cannot solve the problem of affordability among low-income renters. There is no doubt that the problem exists -- that a sizeable group of renter households have incomes insufficient for them to be able to afford adequate housing on the private rental market. But this situation is not an instance of failure in that market and must not be treated as such. As socially desirable as it might be to hold rents low so that needy households can better afford adequate accommodation, a policy that attempts to do so by intervention in the private rental market can only hinder that market's performance of its task: providing and distributing rental housing in general.[11]

The Lack of New Low-Rent Units

Although most of Ontario's rental markets are very tight, especially for low-rent units, very little new construction is targeted at the low-rent market. The evident excess demand and the lack of new supply seem to indicate that the market has failed to reach a proper equilibrium in the low-rent sector.

This situation, however, seems less evidence of market failure than of existing market constraint. A rental market includes a wide variety of dwellings of differing qualities and locations and correspondingly differing rents in various submarkets. If excess demand for one portion of the stock cannot be economically served by new construction, the result in an unconstrained market will be increased rents both for that stock and for the stock at successively higher price and quality levels until the adjustments reach a level that can be economically served by new construction.

The process of demand response is clearest if examined step by step. One would expect an unconstrained rental market to respond to excess demand in its low-rental submarket as follows:

- Rents begin to rise in the low-rent stock.

- Rising rents cause some existing tenants to reconsider their decisions to occupy this stock. Some choose to save on rent by moving to smaller units or switching to shared

accommodations. Some of the relatively more affluent move to higher-rent units (since the gap between low-rent and high-rent stock has narrowed). Others choose to purchase a home. These changes dampen some -- though probably not all -- of the excess demand for the low-rent stock.

- If the cost structure of new rental construction is such that low-rent units are economically feasible to produce, the rise in rents and the prospect of profits encourages some new construction in this submarket, which satisfies some of its excess demand. This response is, however, unlikely because the cost of producing new rental units is generally too high to allow effective competition with older stock. In most of the province's major rental markets, neither public nor private rental-housing developers are currently able to produce new rental housing with rents comparable to those in the existing stock, unless they are also able to obtain large subsidies from governments.

- More likely, the rising rents in the low-rent stock lead to an increase in demand for and, consequently, increased rents in parts of the medium- and higher-rent stock as well. Since these markets are more likely to be able to be economically served by new construction, increases in supply occur there.

- Ultimately, the changes in the price/quantity demands of the market brought on by the initial excess demand in the

low-rent stock and the increased supply in the medium- and higher-rent stock lead to equilibrium, with higher rents and less quantity demanded in the low-rent submarket and increased demand and supply in the medium- and higher-rent submarkets.

The crucial element in this adjustment process is the ability of the market to respond to excess demand by increasing rents. If this response does not -- or cannot -- occur, the other adjustments necessary to restore equilibrium are unlikely unless some other form of incentive (such as a subsidy) is instituted to encourage new construction. Thus, given the current restraints on rent increases in Ontario's pre-1976 rental stock, it is not clear that excess demand in the low-rent submarket with a concurrent lack of new production is evidence of market failure.[12]

Rising Construction Costs and the Existing Stock

Rents in the existing stock are not based on the costs of producing that stock; rather, in the absence of constraints, they are generally based on what the market will bear. This market rent tends to be based on replacement cost -- that is, the cost of <u>new</u> construction (less an amount to account for any differences in quality between new units and existing ones). As a result, rents for existing units may be higher than they need to be to provide an adequate return

to their owners. If so, these landlords may be obtaining a windfall profit at the expense of tenants. Some analysts consider the presence of windfall profits or losses to be a signal of market failure, though this case is not clear-cut.

The causes of today's sharply increased costs for new construction are at least twofold: 1) inflation, and 2) higher real costs for new units resulting from rises in the real costs of land, materials, and labour and from increases in building standards. For simplicity's sake, the two are best examined separately.

Inflation per se does not appear to lead to windfall profits for landlords. To the extent that they and other market participants expect inflation and discount it into their cost-revenue calculations, no market distortions result. Unanticipated inflation or different market participants' having differing expectations of inflation is another matter. Landlords, like all owners of real property who have mortgages, have benefited from unanticipated inflation during the past decade. Excepting cases in which regulation has restrained rent increases, the money values of their properties have generally risen with the inflationary rise in replacement costs, whereas the money values of their loans have remained constant; thus, the real values of their equity have increased.

Clearly, unanticipated inflation may have given windfall gains to the owners of mortgaged rental properties (and windfall losses to the holders of their mortgages). It is less obvious, however, that tenants have been

disadvantaged. The transfer of wealth has been not from tenants to landlords but from lenders to borrowers. Providing that inflation has not eroded the real values of tenants' incomes, there is little argument for not maintaining the real value of rents. In fact, restricting rent increases to less than the rate of inflation would confer a windfall advantage to tenants.

Changes in the real costs of construction would also be reflected in a higher overall rent structure and thus may result in windfall gains to the landlords of existing rental properties. In this case, however, tenants would have been losers since their rents would have risen in real terms.

To the extent that rising rents resulting from unanticipated inflation and the higher real costs of rental construction confer windfall profits on landlords of the existing stock, it is possible to argue that there is evidence of market failure. Any attempt to offset this presumed failure must, however, take account of some important considerations:

- Inflation and changes in the real costs of construction have effects that are similar for all investments with significant lifespans; for example, residential and commercial buildings face the same situation. Controlling the rate of rent increases in residential buildings while leaving other types of property alone would reduce the attractiveness of rental housing as an investment compared to that of other types of property.

- Most new rental properties must endure negative cash flows in their early years. Rents that increase as time goes on are now generally considered a prerequisite to project viability. So is the likelihood of capital gains. Increases in the values of rental property must be based on its capacity for increased revenue through higher rents.

- The ground rules for lending on new rental construction have changed considerably since the period before high inflation. Short-term mortgages are much more prevalent, and interest rates incorporate a premium reflecting lenders' uncertainty about future trends in inflation. Consequently, landlords appear to have fewer prospects for windfall gains from unanticipated inflation. In fact, there is a real possibility of their suffering windfall losses: a landlord who takes out a mortgage with an interest rate that reflects a particular anticipated rate of inflation may incur a drop in net revenues as a result of an unanticipated drop in inflation.

In today's markets, it is also debatable whether the apparent windfall profits described here are actually instances of market failure. Some analysts consider them such. Others, however, may view them as falling within the range of possibilities that induced the investor to acquire the property; in this view, such profits are a reasonable return on investment and no failure exists. In a given

situation today, the decision as to which argument applies would likely depend on when the initial investment was made.

High Rents in Desirable Locations

Some areas are more attractive as residential locations than others, and the desirability of some areas increases as cities evolve. The bidding up of land values and rents in a relatively desirable area is often closely followed by the demolition of some of its older low-rent buildings to make way for higher-rent new ones. This process erodes the stock available for lower-income tenants, who, over time, may be effectively excluded from living in the area.

Differences in land values and rents among areas reflect the market's method of rationing a scarce resource among competing needs. Land values and rents are high in desirable areas because so many people wish to live there; all of them cannot be accommodated, so prices and rents rise, encouraging some to seek housing in less desirable but cheaper locations.

An assessment of whether this phenomenon constitutes evidence of market failure depends on one's view of the appropriateness of the price-rationing mechanism as a method of allocating a social good such as housing. It is an illustration of the market's operating as it is meant to in an economic sense. In social terms, however, it does have undesirable ramifications for affordability and security of

tenure for those tenants whom it forces out of certain areas.

Long Lead Time for New Supply

New rental housing takes a long time to plan and build in present-day Ontario -- a typical large project takes at least two years from the beginning of land assembly and planning to units' being ready for occupancy (construction alone takes an average of more than fifteen months. Considerable amounts of time also go into designing and redesigning to meet building and environment-control codes, into passing the municipal-approval process, and, if necessary, obtaining re-zoning.) A supply-response period of this length could give landlords an opportunity to take advantage of excess demand by imposing excessively high rent increases during the period prior to the provision of new supply. Before deciding that this possibility constitutes market failure that would justify intervention in the market, it is necessary to consider why this situation can occur and whether any means exist for directly countering the delays that cause it.

Since most rental markets in Ontario are characterized by growth, there are generally buildings under construction that will provide a supply of new rental units whether demand increases or not. For example, at the end of 1983, Ontario had under construction a total of 15,372 apartment

units; although some were planned for condominium ownership, most were designed for rental.[13] Investors in these projects have gambled that, upon completion, demand will be sufficient to absorb this new supply.

Because some new units are almost always under construction, a free rental market normally experiences excess demand only when demand increases faster than has been expected and outstrips the new supply that is in the pipeline. Then the market tightens because the long lead times required for construction mean additional new supply cannot be forthcoming for some period.

It is important to note that the delayed supply-response can also produce the opposite situation. Demand may increase more slowly than expected, and sometimes it actually drops. Before these market signals can begin to affect the supply of new rental units, the pipeline must be emptied. In severe cases -- such as Windsor in 1981, Sudbury in 1974 and 1979, and Calgary and Edmonton today -- the result is a dramatic oversupply that causes falling rent levels and severe losses or sometimes bankruptcies among rental investors.

Clearly, improving the responsiveness of supply to changes in demand would serve both landlords' and tenants' interests, and some streamlining of procedures appears possible. Nonetheless, the nature of construction is such that there will always be a significant time lag before supply can be expected to respond to a change in demand. This characteristic of rental-housing markets may constitute

an element of market failure and justify some sort of rent-stabilization program to ensure that landlords do not impose inordinate rent increases on tenants in the interim. (A similar argument could be made for the protection of landlords when demand drops or increases more slowly than expected). Such a rent-stabilization program must not, however, be so restrictive as to discourage new supply; in other words, it must permit rent increases sufficient to allow an attractive return on investment in new rental buildings.

Land-Use Controls

Restrictions on land use limit the areas in which new rental development can occur. Thus, they may limit new rental supply and lead to increases in the price of land and in rents that are greater than would otherwise occur. Rezoning may be possible in some cases, but the process can be lengthy and may add to costs. In addition, limits on the supply of land for high-density building hinder competition (and ultimately contribute to higher rent levels) by restricting the entry of new developers into the market.

Land-use controls are a reality in today's rental market. They can affect the market in much the same way as the restricted availability of land discussed previously, affecting rent levels in existing buildings by restricting new supply. They may also create an oligopolistic market.[14]

Changes in controls are likely to have effects on the market that are beneficial or detrimental depending on one's viewpoint. A relaxation in controls may lead to higher land prices (and windfall profits for owners) by encouraging non-residential uses in areas where they were previously not allowed. On the other hand, such a relaxation may also lead to an increased supply of land for rental housing and lower land costs (and windfall losses to existing landlords to the extent that these lower costs are reflected in lower rents). It seems clear that controls themselves represent a significant imperfection in the market, particularly if they result in a land supply insufficient to ensure competition; it seems equally clear that changes in these controls can lead to windfall gains or losses.

The Restraint of Supply by Oligopolistic Landlords

To the extent that rental markets are monopolistic or oligopolistic -- that is, that they have only one or a few current or potential suppliers -- it may be possible for suppliers to collude, restrict supply, and obtain higher rents than would be possible on a free market.

Ontario's major rental markets are not monopolies or oligopolies. The province's landlords are numerous and they include a diversity of companies and individuals who cannot be seen as generally prone to collusion. Moreover, entry to the rental market as a landlord is an easy proposition

compared to entry into the market as a supplier of most commodities and services. In most rental markets it seems certain that abnormal profits on the part of existing landlords would stimulate new supply from entrepreneurs close to the industry who saw the opportunity for profit. Land shortages might prevent this new supply from appearing in the location under the most demand pressure, but it would be forthcoming in some part of the market.

This open competition may not, however, exist in all of Ontario's rental markets, however. Some small ones, for example, those in small towns, may face a situation in which one or two landlords control all the rental units and either they control all the available suitable land or few entrepreneurs are in the area. In such a case, there may be market failure in the form of opportunities for restriction of supply and abnormal profits.

Tenants Who Can Be Exploited

A tenant's main protection against exploitation by a landlord is a freely operating market in which alternative accommodation is available and the tenant has the option of moving. What restrains the landlord from imposing inordinate rent increases is not whether the tenant actually moves but the knowledge that he or she has the ability to do so. However, some tenants, such as elderly or disabled people, and those who have language difficulties or many children,

have less mobility. Even in a balanced rental market that has alternative rental housing appropriate to their needs, they may be hindered from moving because they have limited information, mobility problems, or difficulty assuming moving costs.[15] These tenants may be vulnerable to exploitation through landlords' charging them higher-than-market rents.

It appears unlikely that most landlords could take advantage of tenants whose ability to move is restrained. To do so would require that tenants be classified according to their ability to move and that those who are relatively immobile be charged higher rents than those who are mobile. Such discrimination would be difficult in many types of buildings, especially large ones in which those who set the rents may not know tenants personally. Nonetheless, it is possible that some unscrupulous landlords find ways to institute such a practice since it would be in their financial interest to do so. To the extent that this sort of discrimination exists, there appears to be evidence of market failure.

Inadequate Assessment of the Economics of New Construction

In an inflationary environment, rents increase over time, as does the value of rental property. In assessing the economics of a new rental project, investors and financiers must take full account of these factors since they are a

major determinant of its long-term viability. Failure to do so results in the calculation of initial economic rents that may be higher than necessary; in consequence, some proposed projects may not proceed, even though they would have made economic sense had the long-term view been taken. The result may be restrictions in the supply of new rental housing and ultimately higher-than-necessary rents.

Although assessments of the financial viability of real estate projects do take account of the likelihood of rent inflation and higher property values, it is notoriously difficult to forecast these variables into the long-term future. They will vary for different market areas and for different types of buildings in the same market area. Also, the level of overall inflation will have a major impact on rent increases in all market areas, but future trends in this variable are very uncertain.

Indeed, even in today's inflationary environment, rents are not guaranteed to rise. Witness Calgary and Edmonton where, two or three years ago, it appeared that rents would rise inexorably in the recently decontrolled markets; vacancy rates now are more than 10 per cent. Similarly, rental property does not always appreciate in value: in the City of Toronto, the real value of rental apartment buildings declined significantly between 1974 and 1980 -- inflation totalled 88 per cent during that period but the average unit price of the buildings increased by only 13 per cent (Smith and Tomlinson 1981).

Added to these uncertainties, which prevail in any rental market, are the difficulties faced by investors in rental housing in Ontario today: the fact that the low rents of the large stock of rental units subject to rent review make demand for high-cost new units unstable, and the possibility that new units may become subject to rent review in future and thereby not realize the level of appreciation they might obtain in a free market.

Doubtless, these uncertainties in assessing future prospects for rents and capital appreciation constitute a form of market failure in the markets for real estate financing. To overcome this problem, financial institutions need to develop mortgage instruments and underwriting guidelines that will better provide the level of financing necessary for new rental housing in an uncertain inflationary environment while spreading the considerable risk equitably between investor and lender.[16]

Evidence of Rental Market Failure

The analysis of the preceding pages suggests the presence of elements of market failure in the operation of rental markets in Ontario. To review, the problems identified include:

- Excess demand exists, particularly in the low-rent part of the market, although the lack of a supply response is not

clear evidence of market failure. An alternative explanation, consistent with the operation of a free rental market, is that high-cost new construction cannot always provide supply to all parts of the market, particularly the low end. However, new units in the medium- and high-rent submarkets can, through adjustments in rents for the low-rent stock and consequent changes in demand, satisfy excess demand in the low-rent submarket.

- Windfall gains can accrue to landlords of existing properties as a result of unanticipated inflation of increases in the real costs of construction or land. Both kinds of increased costs lead to higher rents for new units and raise market rents for existing ones, a situation that some analysts consider evidence of market failure.

- The price-rationing mechanism for rental housing can lead to significant increases in rents in desirable locations, putting some current tenants at a disadvantage and excluding those with low incomes from living there. An assessment of whether this process constitutes market failure depends on one's view of the appropriateness of the price-rationing mechanism as a means of allocating a social good such as housing.

- Because producing new rental units involves long lead times, it is conceivable that in situations of extreme excess demand, landlords could impose inordinate rent increases on tenants without facing the restraining

influence of increased vacancies. In a free market, this phenomenon would likely be temporary since new supply would alleviate the excess demand over time and rents would return to a more normal level.

- Part of the reason for the lengthy lead times in the production of new rental housing is the municipal regulatory process, which delays new construction. These delays can raise costs, as can the restrictions on the supply of suitable land that result from zoning and other regulations in desirable areas.

- In some small rental markets, monopolistic and oligopolistic landlords may be able to restrict supply, forcing rents higher than they would be in a free market. This problem does not appear to exist in larger rental markets because of the number and diversity of landlords and of potential entrepreneurs who could produce additional rental housing if excess demand occurred.

- Some tenants are relatively unable to exercise market choice because of immobility, unawareness of trends in the rental market, or inability to afford moving costs. Unscrupulous landlords may exploit them by charging rents higher than those charged other tenants. While not likely to be a major problem with most landlords, such practices may occur, especially in smaller buildings.

- Because of uncertainty about inflation and future market conditions, current methods of assessing the economic

viability of new projects may not adequately reflect their prospects for capital appreciation and future rent increases. This lack may lead to higher-than-necessary economic rents for these projects and thus discourages needed new rental investment.

Some of these problems, such as the effects of municipal regulations on the supply of land for new rental housing and on the length of lead times for new construction can be characterized as resulting from government actions. Others, such as the use of the price-rationing mechanism to distribute housing, require a political judgement as to whether market failure is involved. The fact that capital appreciation and future rent increases may not be adequately reflected in assessments of the viability of new rental projects can be labelled institutional market failure. Still others, such as long lead times for construction, the possibility of oligopoly, and the vulnerability of some tenants to information problems and high moving costs, are elements intrinsic to the rental market that may cause it to deviate from the competitive ideal. Regulation of rents offers a potential solution to some, though not all, of these problems.

RENT STABILIZATION

Is rent stabilization through a program of rent regulation an appropriate means of countering the rental-market

failures identified in the previous section? Any attempt to answer that question requires some background information. Consequently, this section offers a general rationale for a rent stabilization policy; it goes on to describe past and current policies and programs that have been directed at the Ontario (or national) rental market and to evaluate their success in stabilizing rents.

The Rationale for a Program of Rent Stabilization

The rationale for a program of rent stabilization is that the private market does not always operate in the most efficient and fair manner. The presumption is that one can design a program that will minimize or eliminate the effects of identified imperfections or failures in the market.[17]

Granting this presumption, the designers of such a program need to ascertain:

1. The scale of intervention required. In other words, is it necessary to replace the market entirely?

2. Assuming it is not necessary to replace the market entirely, whether it is possible to introduce a rent-stabilization scheme that will be effective at alleviating the designated market imperfections and does not have serious negative impacts on some other aspects of the market.

The previous discussion has indicated that the rental market can work despite some inefficiencies. It has supply and demand sides that interact to reach an equilibrium price-quantity trade-off for rental units of differing qualities and locations. Both supply and demand appear to be sensitive to changes in unit prices over the long term. The market failures identified do not appear to warrant the replacement of the market. The key then is to design a program to deal with its imperfections while ensuring the maintenance of its essential elements. Without due regard for these essential elements and for the overall efficiency of the market itself, the solutions may turn out to be more costly than the problems.

Past and Current Rental Housing Policies and Programs

In the past, as at present, Ontario's rental-housing markets have experienced a variety of government interventions, ranging from subsidies for private construction to rent regulation. It is instructive to examine their success at stabilizing rents, even though that was not the primary goal of some of them.

In making these assessments, it is important to realize that although the specific programs reviewed here are those that have been in place during the past decade, government housing programs of one sort or another have existed for a long time.[18] Thus, the market before the installation of,

say, the rent-review program cannot be characterized as having been a competitive market without any intervention.

Private Rental Subsidy Programs

The past decade has seen a number of subsidy programs aimed at stimulating private rental construction in Canada as a whole and in Ontario specifically. They were designed to make investment in private rental construction a viable economic proposition by providing subsidies to bridge the gap that exists in most markets between market rents and the economic rents on new buildings. These programs included:

- The Multiple Unit Residential Building (MURB) provision of the Income Tax Act, which provided a CCA (depreciation) tax shelter for individual investors in new rental buildings started within designated periods between late 1974 and 1981.

- The Assisted Rental Program (ARP), which provided annual subsidies in 1975 and interest-free loans in 1976 to 1978 to rental developers. ARP assistance was gradually reduced over the first ten years of a new rental project's operation. For projects approved under ARP in 1975, rent increases were constrained to the amount of the drop in assistance plus any increases in operating costs, but these restrictions were removed in 1976.

- The Ontario Rental Construction Loan Program (ORCL), which provided interest-free second mortgages to developers of rental properties. Initiated by the Ontario government in 1981, it was used by many developers to piggyback onto MURB projects. As part of the program, a developer had to agree to offer up to 20 per cent of the units in the project for rent-supplement assistance to income-tested households.
- The Canada Rental Supply Plan (CRSP), which provided interest-free loans to developers of rental properties after the abolition of MURB at the end of 1981. Like ORCL subsidies, the size of the loans varied by project; however, CRSP assistance was not available to MURB projects. CRSP loans were available in 1982 and 1983: limited funds have been allocated for 1984.

The explicit purpose of these programs was not to stabilize rents but to stimulate new rental supply to overcome the tight rental markets that prevailed in most centres in Ontario and Canada. At this they were successful, though at high costs in terms of the subsidies required. A considerable number of units were subsidized; for example, MURB certificates were issued for more than 380,000 units throughout Canada in the 1975-81 period.

As for stabilizing rents, the subsidy programs had mixed results. The increased supply of rental accommodation helped to relieve the pressure on rental markets to some extent. However, these programs were only temporary

expedients, and any rent stabilization they may have achieved will be quickly eroded as rental markets tighten again because of a lack of new private rental construction during the next few years.

Moreover, although these programs were designed to allow developers to offer new rental units at rents lower than would otherwise have been possible, they had an unfortunate negative feature: they encouraged developers to inflate their costs, at least on paper. MURB benefits were related to the amount of soft costs and depreciation of capital that investors could write off against income from other sources -- the larger the costs, the larger the tax write-off. As Gau and Wicks (1982) argue, at least some of the subsidy/tax-shelter benefit of the MURB program appears to have been capitalized in the value of land by developers and thus not reflected in lower economic rents. In the ARP, CRSP, and ORCL programs, the amount of subsidy depended on the gap between a project's economic rent (based on costs) and its market rents -- the higher the economic rent, the higher the amount of assistance. The extent of the real cost increases that resulted from this encouragement to maximize paper costs is unclear. However, it appears to have been part of the reason for the significant increase in economic rents during the past decade.

Thus, while it can be argued that the private rental subsidy programs helped to stabilize rents by providing new supply to relieve extremely tight markets, it also appears

that their benefits in this regard were temporary. The full value of the subsidy was not likely reflected in the rents for the projects created, and since these projects are generally uncontrolled, their rents can be expected to rise in tight markets in the future. To be effective at stabilizing rents, such programs would need to be continued for an indefinite period in order to maintain a steady supply of new rental units.

Nonprofit and Co-operative Housing Program

The federal government's current nonprofit and co-operative housing program is the only significant program providing additional rental housing in Ontario today.[19] It is intended to provide affordable housing to a mix of needy and non-needy tenants who live in nonprofit and co-operative projects. The government subsidizes rents by providing an effective interest rate of only 2 per cent on a loan up to the full capital cost of the project. Part of this subsidy must go towards providing rental accommodation to income-tested tenants, but a large proportion is used to allow the majority of the units to be rented to others at below-market rents.

During the past few years, units financed under this program have accounted for an increasing share of Ontario's rental starts, partly because of an increase in the number of nonprofit and co-operative housing projects and partly

because of the decline in private rental construction in the province.

This program has stabilized rents for tenants in the subsidized projects. Rents in the projects, although not controlled, are usually maintained at below-market levels. For the general rental market, however, this program has not done much to stabilize rents. Because nonprofit and co-operative projects charge below-market rents to all their tenants, they generally have waiting lists, so they are not competitive with private rental projects in the normal sense. It is unlikely that these projects have had a significant impact on rental markets except those in small towns, where they may make up a large proportion of the new rental stock.

Unless the number of units financed under the nonprofit and co-operative housing program is increased so significantly that it becomes, in effect, the main source of rental housing, its effect on the market is not likely to be large. Most Ontario markets have excess demand at the low-rent levels; these subsidized projects sop up part of this excess demand but by no means all of it. As long as any excess demand remains to the private market, prevailing rents there, unless constrained by some other method, will tend to reflect the economic rents of new projects.

Public Housing

Public housing provides government-sponsored rent-geared-to-income units for needy families and individuals. A considerable number of public housing projects were built in Ontario in the 1960s and 1970s, but none are being planned or built at present. The program has been replaced by the nonprofit and co-operative housing program already reviewed.

Since the stock of public housing is limited and since lengthy waiting lists exist for such accommodations in most centres, the effect of these projects on overall rent levels is minimal. Rents are kept low for most tenants of public housing, but the program is not and was never intended to be an effective tool for stabilizing rents in the overall market.

Rent Control

The current rent-control program in Ontario has effectively divided the private rental stock in most major markets into two segments: the controlled sector, in which rental buildings are subject to rent regulation, and the uncontrolled sector, in which landlords can charge whatever the market will bear.

By constraining rent increases in the controlled stock to 6 per cent (unless a landlord can prove greater increases in costs), the rent-control program has tended to stabilize

rents in this stock. Reliable data on the amount by which they have been held below competitive rents is not available, but it seems clear that, in most Ontario markets, rents for the controlled stock are well below the level they would have attained had the market been allowed to operate freely (see Smith and Tomlinson 1981, 107). Clearly, an even more restrictive program (for example, one that permitted no increases of more than 6 per cent regardless of landlord's costs) could have been even more successful in this regard.

Although successful in stabilizing rents in the controlled existing stock, rent control has had several negative results that must be considered in evaluating the program's overall performance:

- By constraining revenue from a selected portion of the rental stock, rent control has constrained the return on investment for a particular type of investor. It has also established a precedent that makes potential investors wary of rental projects.

- As designed, the program appears to encourage landlords to reduce their expenditures on maintenance in an effort to minimize costs and thus try to avoid the lengthy and often difficult process of applying for increases through rent review. The effects of this design on the quality and the life of the rental stock need further investigation.

- By restricting rent increases in the larger part of the rental stock, the program has had a severe impact on the private rental market's ability and willingness to respond to excess demand with the construction of new rental units.

The last point is the one that is of most importance for this report, so it is worth examining in some detail. Ironically, when the government of Ontario imposed rent controls, it deliberately did not apply them to units built after 1975 because it wished to encourage new investment in rental buildings and to ensure that the private rental market could continue to operate in the traditional manner. The theory was that since rents in these buildings were not controlled, new rental construction would not be affected. Moreover, the program itself was intended to be temporary.

In fact, almost ten years later, the program is still in place and returns on new projects are still affected by the rent-regulation process. New projects have to operate in a market in which the prevailing rents are relatively low, and doing so affects profitability in several ways:

1. The relatively low rents in the large stock of controlled buildings establish a market-rent level that is well below the level of economic rents on new buildings; this situation leads to market resistance to new rental buildings.

2. The demand for new units is relatively unstable. Given the wide difference in rent levels between new uncontrolled units and the large controlled stock, many tenants regard living in new units as a stop-gap measure until a cheaper controlled unit becomes available.

3. The gap between the controlled and the uncontrolled submarkets tends to dampen the process of upgrading by tenants, which is an innate part of the rental-housing market and which normally creates an important part of the demand for new rental housing. In an unfettered market, newly formed households tend to rent older and cheaper accommodations. The former occupants, having climbed up the economic ladder, tend to move into a higher-quality, newer rental unit if they do not purchase a home. The existence of rent controls encourages these more affluent households to remain in their controlled lower-rent units.

4. Even if a new rental project can be expected to generate an attractive rate of return in this difficult market, investors are still wary because of the possibility that controls may be extended to cover the newer rental stock. Such an extension could negate the delicate economics of a new rental project by restraining the level of rents expected in the future.

In brief, the fact that the current rent-regulation process applies to only a portion of the rental stock does not mean

that the uncontrolled portion is unaffected. One might argue that the demand that cannot be accommodated in the controlled stock is forced onto the uncontrolled market, despite the significant differential in rents, and that, therefore, this stock is not affected by rent control. However, such an analysis ignores the fact that rent payments are a significant proportion of a tenant's income, so it is logical to expect some tenants to seek to vacate the higher-rent new stock if controlled units become available. Even if a vacating tenant is immediately replaced by another tenant (which does not always occur, even in a tight market), landlords still have to face turnover costs.

Granted that new rental investment in Ontario would probably have declined in recent years, even in the absence of rent control, because of less favourable demographics and high interest rates, among other factors. However, it is difficult to conclude, as some analysts have, that the rent-control program has not had a significant negative impact on the supply of new rental accommodation.[20] According to vacancy statistics, demand remains strong.

RENT REGULATION AND RENTAL MARKET FAILURE

The preceding discussion of the effects of the current system of rent regulation makes it possible to discuss the appropriateness of a rent-regulation program for offsetting the types of rental-market failure previously identified.

Strategies for dealing with each of the problems are offered, but the emphasis is on what rent regulation can and cannot do.

- <u>Rent regulation could not stimulate new rental supply</u>. Whether the lack of new rental production in the low-rent market constitutes market failure is open to question -- our own assessment is that it does not. Yet even if market failure is involved, it is very unlikely that a case can be made for instituting a program of rent regulation as a means of providing needed new supply. By restraining rent increases, such a program can maintain low rents in the existing rental stock, but there is no rational reason to expect it to encourage new supply.

- <u>Rent regulation could restrain windfall gains, but only at a significant cost to the market</u>. A program of rent regulation could certainly be designed to limit the windfall gains that the owners of rental property receive as a result of unanticipated inflation or increases in the real costs of construction or land. However, such an approach presents several serious problems. One is that restriction of returns on rental properties alone would tend to make alternative investments, such as commercial developments, relatively more attractive unless similar restrictions were placed on all similar types of investments.

Another problem is how to separate anticipated inflation from unanticipated inflation. Analyses of rental

investments today require specific assumptions about future inflation since that will have a heavy impact on the ultimate viability of the project. A regulatory system that attempted to remove windfalls resulting from <u>unanticipated</u> inflation would need to reflect the specific assumptions on which the project was initially based. Also, there would be the question of what to do if inflation (and hence capital appreciation) proved lower than expected. Would higher rents then be imposed on the tenants to ensure a proper return to the investor? If so, how could one ensure that the tenants would not move to less expensive accommodation?

The final question is the serious one of whether such an approach would be consistent with the operation of a market. Rents for all properties would need to be administered, in relation to initial costs, and they would not be responsive to changes in demand. Such a system might be able to operate as long as demand at least equalled supply and landlords could be assured of tenants; however, any further drop in demand would leave the relatively more expensive units prone to high vacancies.

In brief, rent regulation may appear an attractive way of ensuring that both tenants and landlords pay and receive amounts consistent with the costs and expectations about inflation at the time the investment was made; in reality, however, the administration and the operation of such a system would present severe problems.

Recall, however, that windfall gains are not restricted to rental investment. An alternative means of offsetting such gains would be a tax on all capital gains above a given level. This is not the forum for discussing the pros and cons of such a tax, but it appears to offer a better potential solution to the problem than attempting to regulate the returns on one specific type of investment.

- Rent regulation could offset price rationing's negative effects on some tenants. Low-income tenants tend to become excluded from particularly desirable areas because the rents there are driven up by price rationing, the market's mechanism for distributing a scarce good. Are these higher-than-normal increases in rents a case of market failure? The answer depends on whether one regards price rationing as appropriate in the distribution of social goods, such as housing. If it is inappropriate, the question is what method should be used to ration particularly desirable rental housing, for which demand is greater than supply.

Regulation of all rents cannot assist in this regard; it could help low-income tenants to compete but, in the absence of another rationing system, it would only result in waiting lists for particularly desirable accommodation.

A compromise solution might be to regulate rent increases to average market levels for low-income tenants who currently reside in projects. Such a limited system would protect those whom rising rents might force to move out of a particularly desirable area, but it would probably

not unduly affect the market's price rationing mechanism for other tenants.

- <u>Rent regulation could limit the negative impact of long lead times on new construction</u>. To the extent that landlords can take advantage of temporary shortages of rental accommodation to impose rent increases above the normal competitive level, some method of protecting tenants may be appropriate (though an equal case could be made for protecting landlords in the opposite situation). It is important, however, that the protection be structured in such a way as to avoid interfering with the provision of the new supply. If the rent increases are constrained below the level that stimulates new supply, there is danger that the supply mechanism will not operate properly and the needed new supply will not be forthcoming. Therefore, the intent must not be to suppress general market rents but only to curb excessive increases during the period when supply is temporarily suppressed.

The problem is how to design a program that allows realistic rent increases. It is very difficult to forecast market levels of rent into the future with any degree of precision, especially for the rental market as a whole. Simple measures, such as the rate of increase in the Consumer Price Index, have little to do with the costs of new construction and the rate of increase in economic rents on new rental properties, particularly those in the most

desirable locations, which may be experiencing above-average increases in land prices. Thus, the program would have to be carefully designed to allow rates of rent increases consistent with what is happening to costs in the rental market at a given time.

Such a design need not, however, be extremely complex since a system that is fair to tenants but still allows the market to determine the proper level of rents does not have to regulate all rents strictly. Designers could establish some base level of allowable increase (possibly a fixed number of percentage points above the rate of inflation), with all increases above that level subject to some form of arbitration by officials conversant with the market. Restricting rent increases for current tenants to once each year might also help. Vacant units, however, should probably not be subject to restrictions; doing so could require a level of policing and bureaucracy that seems inconsistent with an intention of maintaining a free market to the extent possible while not disadvantaging existing tenants.

- <u>Rent regulation cannot properly address delays and higher costs caused by municipal regulations</u>. Of the many factors involved in the long lead time now required for new rental construction, a major one is the duration of actual construction. Although new methods of increasing worker productivity and new technology may provide reductions in

the future, it probably cannot be streamlined to any great extent in the short term.

Another cause of slow supply response is delays to construction caused by the regulatory and approval process and by zoning restrictions, which can also lead to increased costs for new rental units that will be reflected in higher rents.

Some of these factors may be more flexible than construction times. For example, a critical factor in the duration of the design stage is the number of criteria that a new project must meet. Stringent building codes, standards of structure design, and environmental controls all require time-consuming negotiations and redesign to comply with regulations. Although the maintenance of certain standards is clearly desirable, excessive regulation can contribute to unnecessary delays.

Similarly, the time required for the municipal-approval process is influenced by many factors, including the size and competence of the municipal staff in relation to the volume of applications on hand, the number and degree of flexibility of criteria that plans must meet, the degree of support or opposition for the project within the existing community, and the completeness and accuracy of the submission itself. Added delay arises when a developer must apply for re-zoning. Any variations in these factors could significantly alter the time involved in the review process.

Although this problem is undoubtedly related to the operation of the rental market, it does not appear to be one

that can be solved by rent regulation. However, streamlining the whole municipal-review process would probably benefit the operation of the rental market, and, as long as it did not compromise the intent of the regulations, would likely be welcomed by most participants in the market. The question of whether <u>all</u> the regulations and restrictive zonings that exist in most municipalities are necessary is beyond the scope of this study: however, there is clearly a need for <u>some</u> regulation, so some delays in this regard seem inevitable.

- <u>New sources of supply, not rent regulation, are the best answer to monopolies and oligopolies</u>. The situation of only a few landlords' controlling the rental market is not prevalent in most centres in Ontario today. It may, however, occur in some smaller localities where there are no local entrepreneurs or no suitably zoned land available.

Establishing a rent-regulation system to deal with this problem would attack the symptom, not the cause. A far more effective response would be the provision of additional sources of supply. Municipalities could achieve this end by ensuring the proper zoning of enough land to allow other participants into the market, by promoting the locality's rental prospects to developers in neighbouring areas, or, if no private entrepreneur is available, by establishing a nonprofit corporation to develop rental housing.

The last option is particularly attractive at present because of the current federal program that provides

nonprofit developers with subsidies to write down their interest rates to 2 per cent. It seems improbable that this program will continue indefinitely in its present form; however, a market in which a monopoly or oligopoly is truly restricting supply and charging rents above competitive market levels could likely be economically served by a nonprofit housing development that used unsubsidized mortgage funds.

- <u>Information and assistance could protect less mobile tenants better than rent regulation could</u>. For the vast majority of tenants, a competitive rental market in which alternative accommodation is available provides protection against inordinate rents. However, some tenants, because of age, disability, or other disadvantages, may not be aware or able to take advantage of the option of moving to another dwelling; some landlords may take advantage of this relative immobility and charge them rents higher than those charged other tenants.

A rent-regulation system could address this problem, but the value of its doing so must be weighed against its costs in terms of the bureaucracy and other inefficiencies it would create. An alternative approach would be to increase the market information available to such tenants and perhaps to provide assistance to those who need to move to alternative accommodations. Both the information and the assistance could likely be provided through existing social

agencies, which, in many cases, are probably in regular contact with these tenants.

- Rent regulation is part of the problem of inadequate account being taken of future rent increases and capital appreciation in assessing new rental projects. Predicting likely rent rises and capital appreciation on a new rental project is difficult in today's uncertain times. The existence of rent control and the possibility of its extension to the newer stock make these predictions more perplexing than they would be if investors and lenders had to contend with only the market and likely inflation levels. Investors would have a greater degree of certainty about the viability of new projects if they were assured that future rents would be determined by the market, rather than imposed by regulation.

As for the provision of financial instruments that would better reflect the requirements of rental-housing investment, a recent study concluded that two areas need further effort:

> a) research into and education of the financing, investment and developer/builder sectors with respect to i) optimal design of market oriented loan instruments and ii) hedging alternatives available in options and future markets, and b) introduction of hedging devices or facilities such as mortgage rate insurance which appear to require government initiatives because of the nature of risks, economies of scale or the cost of information. (Jones 1983, 55)

Conclusion

Rent regulation, it appears, is not the most appropriate means of addressing the rental-market problems identified in this study, although it does offer a potential solution in some cases. However, as this study has stressed throughout, it is essential that the design of any program of rent regulation ensure that it addresses only the problems intended and that other aspects of the rental market do not suffer side effects that make the cure worse than the disease.

APPENDIX

The Demand for Rental Housing in Ontario

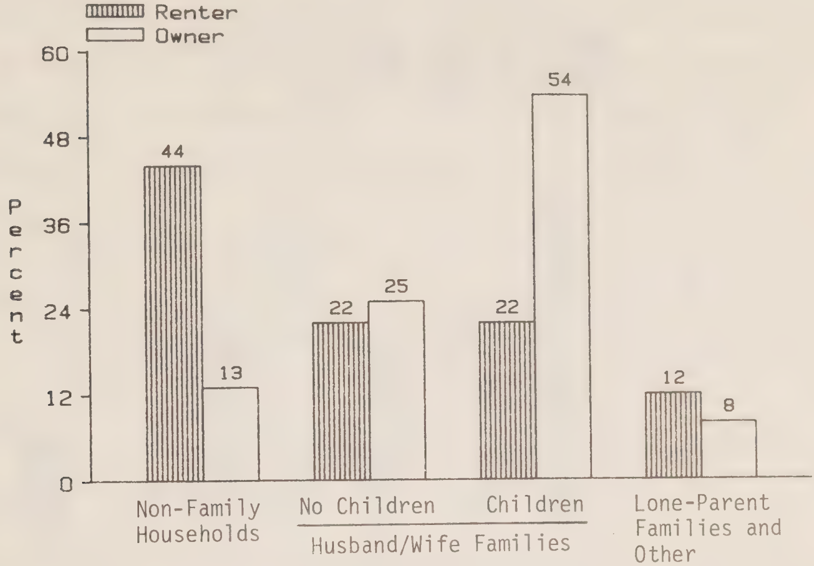
In 1981, Ontario had almost 1.1 million renter households. During the 1981-86 period, it is projected that renter growth in Ontario will average 15,000 to 20,000 households annually. The characteristics of the province's renter households in 1981 are briefly examined here to provide some background on the nature of the demand for rental housing.

Types of Renter Households

All types of households choose to rent accommodation; overall, however, Ontario's renter households show significant differences in composition compared to owner households (see Figure 1). Non-family households (defined by Statistics Canada as those composed of either one person or two or more unrelated persons) account for a much larger proportion of renter households than of owner households -- 44 per cent of all renter households versus 13 per cent of all owner households.

Husband-and-wife families, with and without children, make up a proportion of renter households that is sizeable but much less significant than is the case for owner households. Particularly noticeable is the difference for "conventional" families of a husband, a wife, and children; they account for 54 per cent of owner households but only 22

FIGURE 1: Renter and Owner Households by Type, Ontario, 1981



SOURCE: 1981 Census of Canada

per cent of the renter households. On the other hand, lone-parent and "other" types of households form a proportion of renter households that is relatively small but larger than their proportion of owner households. Thus, households with no children are a larger proportion of renter households than of owner households. Children were present in 62 per cent of all owner households in Ontario in 1981 but in only 34 per cent of all renter households.

As shown in Figure 2, almost half (47 per cent) of all renter households are headed by a person less than thirty-five years old. Thirty-five per cent have household heads aged thirty-five to sixty-four years. Fewer than 20 per cent have a household head aged sixty-five or more. This

FIGURE 2: Renter Households by Type and Age of Head, Ontario, 1981

SOURCE: 1981 Census of Canada

distribution constrasts with that of owner households; only 21 per cent of owners are less than thirty-five years old, but 62 per cent are aged thirty-five to sixty-four. Like renter households, owner households have fewer than 20 per cent of their heads aged sixty-five or more.

These differences between the types and age structures of renter and owner households reflect the pronounced lifecycle tendency among households to either own or rent:

- The relatively high proportion of renter households with a younger head is indicative of the fact that most

unmarried people initially rent a dwelling and many young couples rent before purchasing their first home. In many cases, the preference for renting, rather than owning, among the young results from problems of affordability or the necessity of saving for a down payment on a home. In others, the reasons are lifestyle considerations.

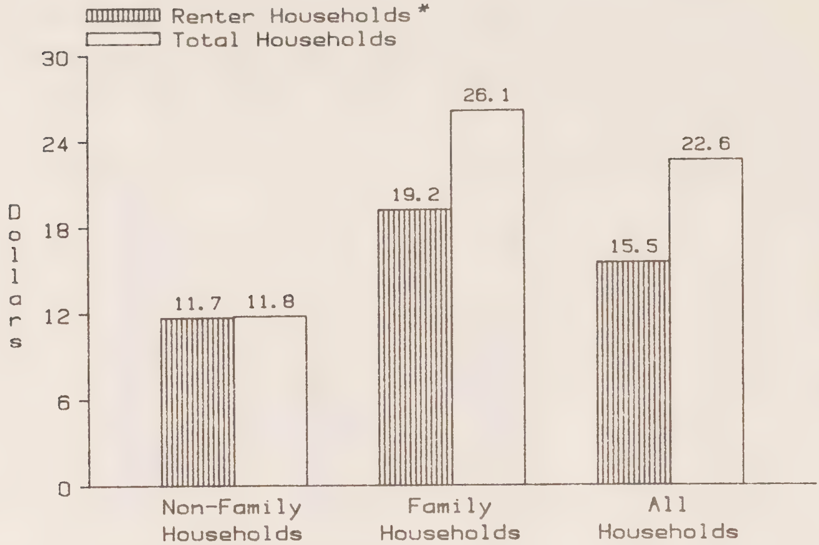
- Households with heads in the thirty-five-to-sixty-four age group are more likely to own; the proportion of owners rises to more than 75 per cent for households with heads about fifty years of age. It appears that a large proportion of the households in these middle-age groups who rent do so because they simply cannot afford to own.

- The proportion of renter households increases as the age of the head passes fifty-five. In many cases, this phenomenon reflects the smaller accommodation needs of families whose children have left home or in which one of the spouses had died. The availability of more-suitable (often subsidized) rental accommodation may also induce some older people to move into it. In some cases, the lower incomes associated with age may cause some owners to sell, realize their equity, and move into rental housing.

Renter Household Incomes

The fact that the own-rent tenure choice is partly influenced by lifecycle tendencies should not cloud the fact that many households rent because they cannot afford to own.

FIGURE 3: Median Incomes of Households by Type, Ontario, 1980



* Non-farm renter households

SOURCE: 1981 Census of Canada

As shown in Figure 3, the incomes of renter households are generally lower than those of owners. The 1980 median income for non-farm renter households in Ontario was $15,500. The comparable figure for all households in Ontario, including both renters and owners, was $22,600.

To some extent, this lower median income among renters can be explained by the high proportion of non-family households in rental accommodation since non-family households tend to have relatively low incomes. As Figure 3 shows, the median income for non-family households in Ontario in 1980 was virtually the same for both renter and total households.

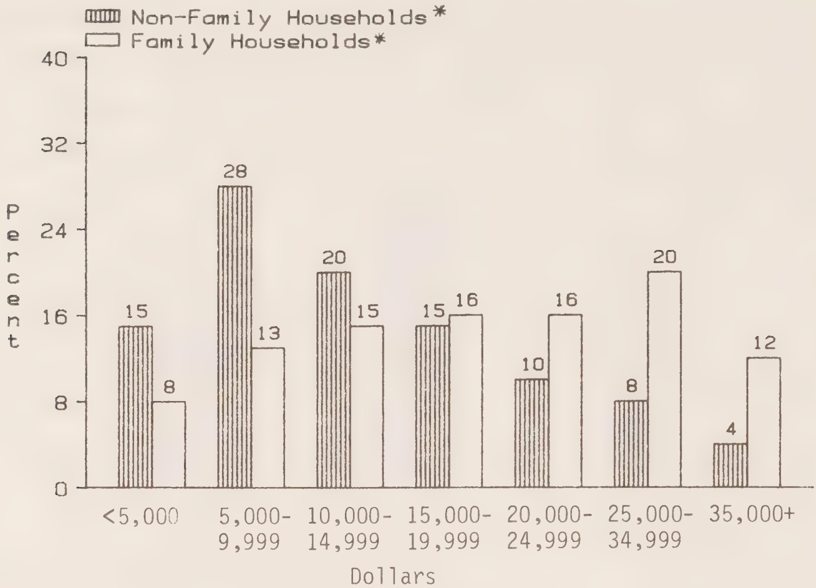
As Figure 3 also shows, family households in rental accommodations tend to have much lower incomes than family households who are owners (though the former's incomes average well above those of non-family households). In 1980, the median income for renter family households in Ontario was $19,200, well below the $26,100 median income for all family households. The relatively lower incomes among family renter households compared to owner households is consistent with the previously noted point that many households rent because they cannot afford to own.

Incomes among both family and non-family renter households are widely distributed (see Figure 4). Forty-three per cent of all non-family renter households had 1980 incomes of less than $10,000, while only 12 per cent had incomes above $25,000. Almost one-third of the renter family households had 1980 incomes of $25,000 or more while 21 per cent had incomes of less than $10,000.

Affordability

The available data suggest that although most renter households have little difficulty affording their current accommodations, a significant minority must devote a very high proportion of their income to rent payments. Exactly how many households fall into this category is open to debate. One problem here is setting an appropriate rent/income ratio. Various analysts place the cut-off point from 20 to 35 per cent.

FIGURE 4: Income Distribution of Renter Households, Ontario, 1980

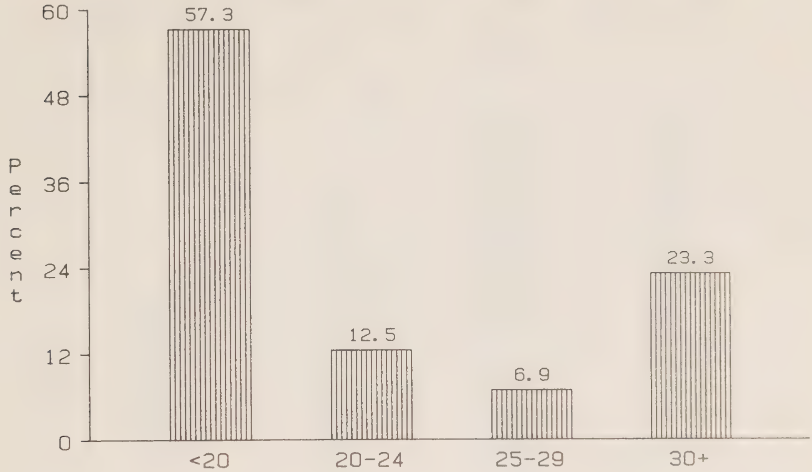


* Non-farm renter households

SOURCE: 1981 Census of Canada

Different data sets and different ways of analysing data also produce different results. Information from the 1978 Statistics Canada Household Income Facilities and Equipment (HIFE) microdata file on renter households in Ontario not in receipt of direct subsidies, indicates that most can afford their current accommodations. Comparing 1978 rents with 1977 incomes, more than half these households paid less than 20 per cent of their income in rent, as shown in Figure 5. However, for 23 per cent of them, 1978 rents amounted to more than 30 per cent of 1977 incomes.

FIGURE 5: Unsubsidized Renter Households by Rent/Income Ratio, Ontario, 1978



SOURCE: J. Miron, "The Affordability of Rental Housing in Ontario: Empirical Findings" as quoted in Ontario Ministry of Municipal Affairs and Housing (1982)

The 1981 census showed a somewhat higher figure for Ontario households paying more than 30 per cent of their income in rent (28.8 per cent of all renter households). One reason for the difference is that the HIFE data relates only to unsubsidized renter households. Another is that both data sets use the current year's rent and the previous year's income, a methodology that tends to overstate the number of problems households.[21]

Canada Mortgage and Housing Corporation (CMHC) has developed estimates of "core housing need" among renters; these estimates, although based on HIFE data for 1980, appear to be a more reliable indicator of renters' problems

with affordability than either of the other sources noted here, partly because CMHC adjusted the data so that income and rent figures referred to the same year.[22] CMHC estimates that 17.8 per cent of all Ontario renter households cannot afford adequate accommodation without spending more than 30 per cent of their income on rent (1983, 41).

However, regardless of which figures are used, it is clear that a significant proportion of renter households cannot afford adequate accommodation on the market, but that most do not have difficulty meeting the payments for their accommodations.

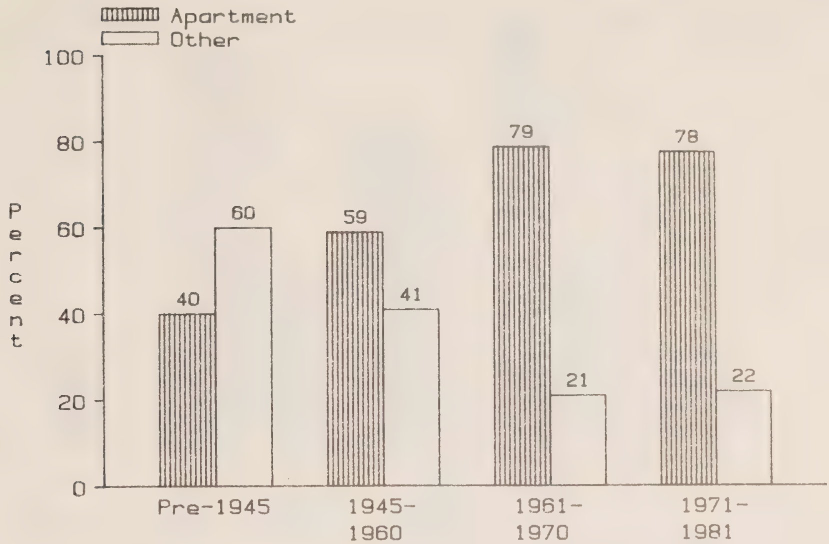
The Supply of Rental Housing in Ontario

The supply of rental housing comprises the stock of existing rental units of all types plus incremental additions to the stock each year as a result of the completion of new rental units (less any losses to the stock from demolitions and conversions of tenure). The characteristics of the rental stock and its owners are of considerable importance to the operation of the market.

Types of Rental Stock

As shown in Figure 6, two-thirds of Ontario's occupied rental stock in 1981 was apartments, most of them in

FIGURE 6: Occupied Rental Stock by Dwelling Type, Ontario, 1981



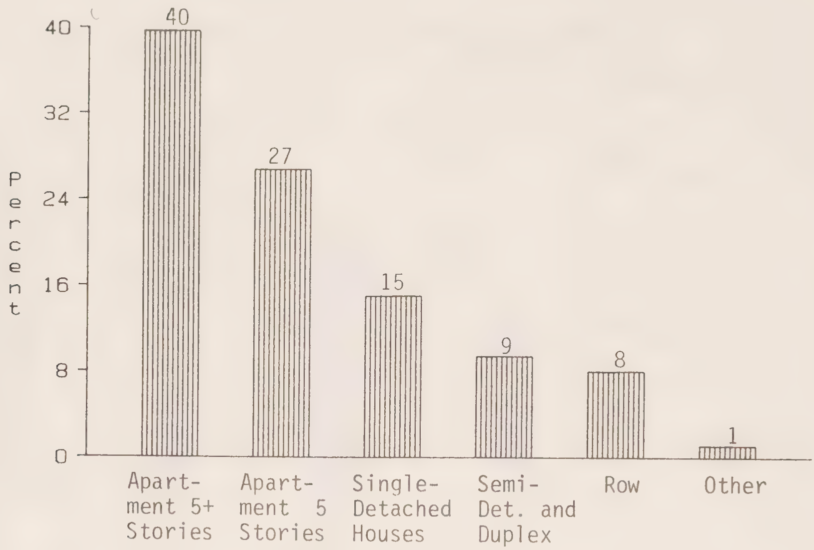
SOURCE: 1981 Census of Canada

highrise buildings. Single-detached units made up another 15 per cent; the remainder comprised semi-detached, duplex, row, and other types of units.

As demonstrated in Figure 7, apartments have accounted for most of the additions to Ontario's rental stock in recent years. In 1981, they made up almost 80 per cent of occupied rental stock that had been completed in each of the previous two decades. In comparison, apartments were a much smaller proportion of the occupied rental stock completed before 1961.

Apartments are an even more important component of the <u>new</u> rental supply than these figures suggest. There appears to have been a switch away from rental tenure in some parts

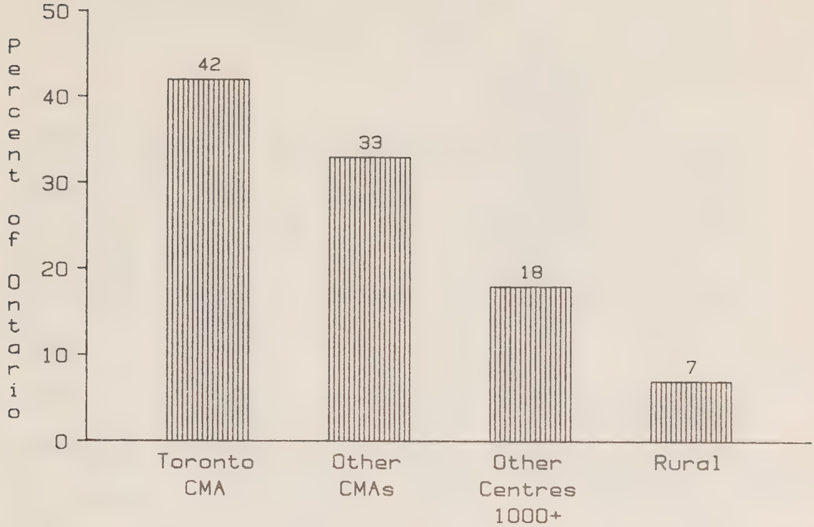
FIGURE 7: Occupied Rental Dwellings by Type and Year Built, Ontario, 1945-81



SOURCE: 1981 Census of Canada

of the existing non-apartment housing stock in recent years. From 1971 to 1981, for example, the total occupied rental stock in Ontario increased by 265,000 units. The number of rental apartments completed and occupied during the same decade totalled 262,000. In other words, apartments filled virtually all of the <u>net</u> increase in demand for rental accommodation during the 1970s. The number of other types of rental units built during the same period was sufficient only to offset the losses to the existing stock from demolitions and changes in tenure away from rental.

FIGURE 8: Occupied Rental Stock by Area, Ontario, 1981



SOURCE: 1981 Census of Canada

Location of Rental Housing

The vast majority of Ontario's occupied rental units are located in urban areas (see Figure 8). Forty-two per cent of the stock is located in the Toronto Census Metropolitan Area alone, and the ten Ontario CMAs together account for 75 per cent of it.[23] Another 18 per cent is in smaller centres of 1,000 to 100,000 people. Only 7 per cent is in rural parts of the province.

In contrast, large urban areas account for a smaller proportion of Ontario's ownership housing, and 22 per cent of it is located in the rural parts of the province. The Toronto CMA accounts for a much lower proportion (31 per

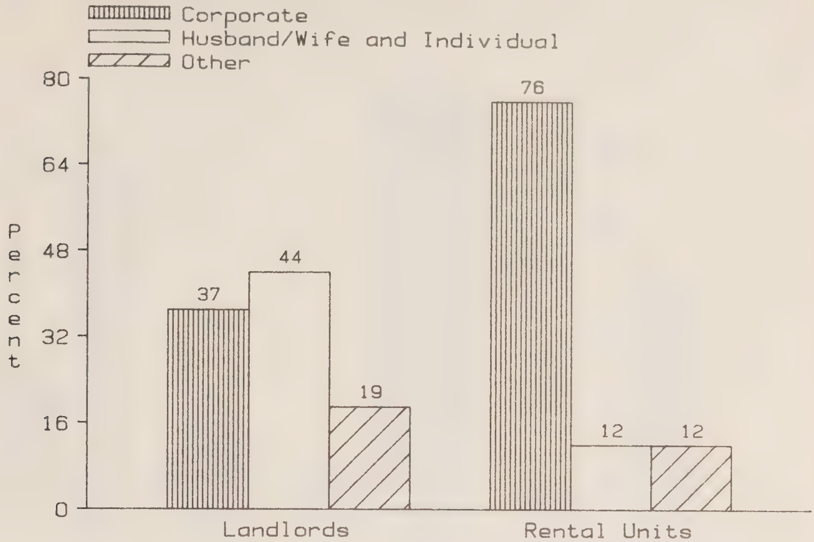
cent) of the owner-occupied stock than is the case for rental housing.

Ownership of the Rental Stock

Privately owned buildings make up most of Ontario's rental housing stock. Unpublished information compiled by the Ministry of Municipal Affairs and Housing indicates that public housing and co-operative and nonprofit housing in Ontario totalled 142,000 units in early 1984. Comparable figures for the privately owned stock are not available; however, by combining the 1981 census figures on the occupied rental stock with estimates of rental units completed since the census, we can calculate that approximately 12 to 13 per cent of the province's rental stock is owned by the public or third-sector groups. Presumably, the remaining 87 to 88 per cent is privately owned.

Great diversity is evident among the private owners of rental housing, although corporate landldords appear to dominate, at least for apartments. As depicted in Figure 9, an analysis of the ownership of a sample of rental apartment buildings in Ontario[24] indicates that only 37 per cent of the landlords were companies, but they owned 76 per cent of the units. Individuals and husbands and wives, on the other hand, made up 44 per cent of landlords, but they owned only 12 per cent of the units. (The "other" landlord types in the sample included partnerships and trusts.)

FIGURE 9: Landlords by Type,
Major Ontario Centres, 1980

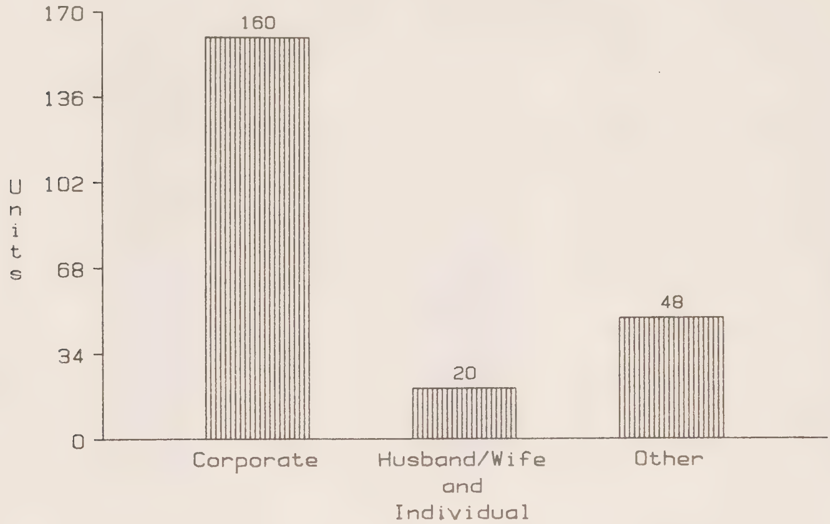


SOURCE: Information from the Ontario Ministry of Municipal Affairs and Housing based on data on apartments of six or more units from Teela Market Survey.

The analysis also showed that the majority of the larger apartment buildings are in the hands of corporate landlords (see Figure 10). The average size of each of the corporate landlord's portfolios was 160 units; the individuals and couples averaged only 20 units, in some cases in more than one building.

Although most of the larger rental buildings are in the hands of corporate landlords, they are not all owned by large real estate companies. As shown in Figure 11, more than half the corporately owned units in the sample were owned by companies with portfolios of only one or two buildings. Companies owning six or more rental buildings

FIGURE 10: Average Number of Rental Units per Landlord, Major Ontario Centres, 1980

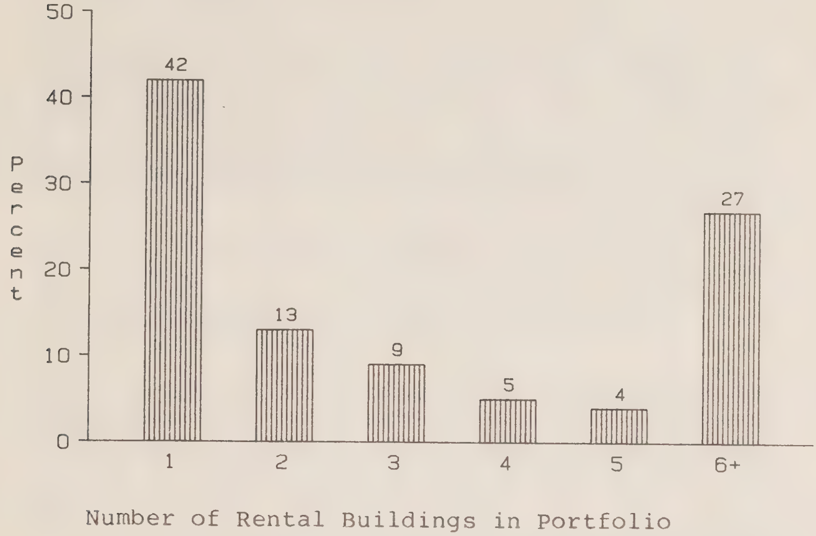


SOURCE: Information from the Ontario Ministry of Municipal Affairs and Housing based on data on apartments of six or more units from Teela Market Survey.

accounted for 27 per cent of the corporately owned units (21 per cent of all rental apartment units in the sample). Some of these smaller corporate landlords, of course, may represent cases of the same principals' owning more than one company. Nonetheless, it appears that a high proportion of the province's larger apartment buildings is owned by companies that have interests in only a few properties.

No firm statistics are available on the types and size of landlords of rental housing other than apartment buildings. However, it seems likely that a much higher proportion of this part of the rental stock is owned by

FIGURE 11: Corporately Owned Rental Units by Size of Rental-Building Portfolio, Major Ontario Centres, 1980



SOURCE: Information from the Ontario Ministry of Municipal Affairs and Housing based on data from Teela Market Survey.

small landlords -- either companies or individuals that have portfolios of only one or a few properties.

NOTES

1. Separate papers commissioned by the Commission of Inquiry into Residential Tenancies examine rent regulation as a policy instrument for alleviating the problem of affordable housing and for complementing the security-of-tenure provisions of the Landlord and Tenant Act. See Denton Marks, Housing Affordability and Rent Regulation, Research Study No. 8; and Marion Steele and John Miron, Does Regulation Work? Housing Affordability Problems, Market Imperfections and Public Policy, Research Study No. 9.

2. For more detail on the market for rental housing, see the appendix to this study.

3. This information is from unpublished data compiled by the Ontario Ministry of Municipal Affairs and Housing.

4. A CMA comprises a large urbanized core plus the main "commutershed" surrounding it. For example, the Toronto CMA covers the area stretching from Oakville on the west to Newmarket on the north and Ajax on the east. The other Ontario CMAs are centred on Hamilton, Kitchener, London, Oshawa, Ottawa, St. Catharines-Niagara, Sudbury, Thunder Bay, and Windsor.

5. The analysis included rental buildings of six or more units in the seven regional municipalities encompassing the Toronto, Hamilton, and Ottawa CMAs. The 435,000 units in the sample accounted for 60 per cent of all rental apartments in Ontario and 40 per cent of the total rental stock.

6. Some corporate principals may, of course, have been counted more than once. See the appendix to this study.

7. Because landlords' costs are relatively fixed, regardless of whether rental units are occupied or not, the difference between a vacancy rate of zero and one of 4 to 5 per cent can signal the difference between profits and losses.

8. The degree to which demand changes in response to rent levels (the elasticity of demand) is a highly complex issue on which further work is required before definitive answers are forthcoming. (Miron, 1983.) But there can be no doubt that the response occurs.

9. Indeed, some evidence suggests that, because of these costs, some landlords, especially small ones, can be best characterized as turnover- or vacancy-minimizers rather than profit-maximizers in the sense that they do not charge the highest possible rents. Rather, they

deliberately underprice their units so as not to risk unwanted vacancies. (See, among others, Downs 1979.)

10. See Cairns (1980) for a fuller discussion of traditional market failures.

11. The issue of affordability is dealt with in another background study prepared for the Commission. See Denton Marks, Housing Affordability and Rent Regulation, Research Study No. 8.

12. This is not to suggest that other factors may not also be involved in restricting new supply; for example, shortages of suitable land may be having this effect in particular locations. The point here is simply that restrictions on rent increases in the existing stock are a plausible explanation for the apparent market failure involved in the lack of new supply in response to the light low-rent market.

13. Given the previously noted constraints on new supply in Ontario, we can assume almost all the rental units were subsidized under either the Canada Rental Supply Plan or the nonprofit and co-operative housing program.

14. The impacts of land use controls on housing costs and rental supply have been the subject of various studies. For further discussion, see Babcock and Bosselman (1973) or Dowall (1980).

15. The most obvious restriction is low income. It is not dealt with here because there is no question that the market cannot provide some low-income tenants with adequate housing at a rent they can afford. The problem is, however, outside this study's terms of reference.

16. For a further elaboration of this issue see Jones (1983).

17. Recall that this study's terms of reference do not permit consideration of affordability as a possible rationale for rent stabilization. It is worth noting, however, that no matter how stable the rent, there will always be some tenants who cannot afford it. It seems clear that a rent stabilization program cannot effectively solve the problem of affordability, though for some groups and politicians, it remains a major rationale for such a program.

18. For example, CMHC's limited-dividend rental housing program was very active in the 1950s, 1960s and early 1970s. Also, before 1972, all owners of rental property could deduct a capital cost allowance for rental properties from income from non-rental sources

for tax purposes. The abolition of this tax shelter for most investors (it still exists for certain corporate investors, primarily real estate companies) made rental housing a less attractive investment and may have been a factor in tightening markets in the first half of the 1970s and in increasing the marginal cost of new supply and consequently in raising rents.

19. From a legal viewpoint, co-operatives are not rental housing. They are included here because they are close substitutes for rental housing, serving most of the same market, and because they receive government subsidies under the same programs as nonprofit rental housing.

20. For example, Miron and Cullingworth argue that "the primary cause of the slump (in rental construction) has been a sluggish demand for rental accommodation. To some extent, Rent Review contributes to this sluggishness by restricting the rate at which rents can increase. Rent Review may thus have caused the slump to be deeper and more protracted than it would otherwise have been" (1983,29). It seems very unlikely that restricting rents would reduce demand -- in fact, the opposite is much more probable.

21. The overstatement would be especially large for the census estimate since average earnings increased by about 12 per cent between 1980 and 1981 but only about 6 per cent between 1977 and 1978.

22. CMHC also addressed the problem of overconsumption and underconsumption of housing by calculating the average rent for an adequate dwelling for each household size and comparing that to income in determining the relevant rent/income ratios for a suitable size of dwelling.

23. The other Ontario CMAs are Hamilton, Kitchener, London, Oshawa, Ottawa, St. Catharines-Niagara, Sudbury, Thunder Bay, and Windsor.

24. The analysis included rental buildings of six or more units in the seven regional municipalities comprising the Toronto, Hamilton, and Ottawa CMAs. The sample was 435,000 units, accounting for 60 per cent of all Ontario's rental apartments and 40 per cent of its total rental stock.

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